NEW ZEALAND COUNTRY REPORT 2018

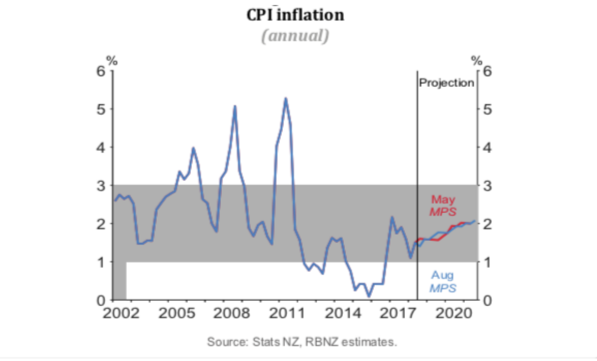
MACROECONOMIC OUTLOOK

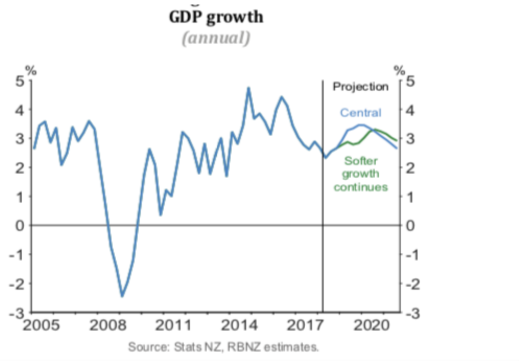
The New Zealand economic outlook remains positive with second quarter GDP growing at a rate of 1.0% (2.7% YOY), 0.2% to 0.5% above market expectations. Growth continues to be underpinned by both Government and household spending, and tourist inflows. The Labour led coalition continues to spend on public services such as health and education and has a large infrastructure program in place related to public transport, roading and housing. The lower exchange rate is also providing support to New Zealand's important export sector.

However, there are some headwinds for the economy. Business confidence is at low levels which could impact further investment and employment opportunities. There has been a recent increase in strike action as various sectors of the economy pursue larger increases in remuneration and better working conditions. Lower business confidence is not unusual with a Labour led coalition and the Government has been engaging with businesses in order to try and address concerns. The housing market has softened in recent times and this along with higher fuel prices may have an impact on household spending.

The global landscape continues to be uncertain. While global economic growth remains strong, downside risks have increased with US/China trade tensions escalating. This could have a negative impact on global growth. Inflation pressures are increasing, and wage pressures are emerging. As a result, Central Banks in advance economies are in the process of removing monetary policy stimulus. To date, these impacts have had little impact on the New Zealand economy.. However, a further escalation of these issues could impact negatively on the New Zealand economy.

The RBNZ continues to hold the Official cash rate at 1.75% and currently expects it to remain at this level into 2020. Inflation remains below the 2% target, but within the 1-3% range at 1.5%. Although the RBNZ sees early signs of the rising inflationary pressures it still believes that the risks to inflation are evenly balanced. As a result, the Reserve Bank has noted the next move in the OCR could be either up or down. Market pricing currently indicates a small chance of an easing in monetary policy.





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Summary of economic projections
(annual percent change, unless specified otherwise)

	Actuals								Projections		
March year	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Price measures											
CPI	4.5	1.6	0.9	1.5	0.3	0.4	2.2	1.1	1.6	1.8	2.0
Labour costs	2.0	2.1	1.8	1.7	1.8	1.8	1.5	1.9	2.0	2.2	2.4
Export prices (in New Zealand dollars)	7.9	-2.7	-4.9	11.5	-9.1	-0.3	4.1	3.3	2.5	0.9	1.7
Import prices (in New Zealand dollars)	3.4	-1.7	-4.0	-3.1	-3.4	1.1	0.5	1.9	3.8	0.9	0.7
Monetary conditions											
OCR (year average)	2.8	2.5	2.5	2.5	3.4	2.9	2.0	1.8	1.8	1.8	1.9
TWI (year average)	69.0	72.2	74.0	77.6	79.3	72.6	76.5	75.6	73.1	72.7	72.3
Output											
GDP (production, annual average % change)	1.6	2.3	2.2	2.6	3.7	3.6	3.8	2.7	2.6	3.4	3.2
Potential output (annual average % change)	1.4	1.7	2.1	2.5	2.9	3.0	3.2	3.1	3.0	2.9	2.9
Output gap (% of potential GDP, year average)	-2.2	-1.6	-1.4	-1.3	-0.5	0.1	0.6	0.2	-0.2	0.3	0.6
Labour market											
Total employment (seasonally adjusted)	1.6	0.6	0.2	3.7	3.2	2.0	5.7	3.1	1.9	1.7	1.5
Unemployment rate (March qtr, seasonally adjusted)	6.0	6.3	5.7	5.5	5.4	5.2	4.9	4.4	4.4	4.2	4.2
Trend labour productivity	1.1	1.0	0.8	0.5	0.2	0.0	-0.1	0.0	0.4	0.8	1.1
Key balances											
Government operating balance (% of GDP, year to June)	-8.9	-4.3	-2.0	-1.2	0.2	0.7	1.5	1.1	0.8	1.3	1.3
Current account balance (% of GDP)	-2.8	-3.2	-3.7	-2.5	-3.6	-2.7	-2.7	-2.8	-3.5	-3.1	-2.7
Terms of trade (SNA measure, annual average % change)	7.9	1.6	-4.3	11.7	-0.3	-3.0	2.7	4.6	-2.5	-0.7	0.7
Household saving rate (% of disposable income)	2.1	2.4	0.5	0.1	-1.5	-1.3	-2.8	-2.9	-2.0	-1.1	0.0
World economy											
Trading-partner GDP (annual average % change)	4.4	3.4	3.3	3.5	3.7	3.4	3.3	3.8	3.8	3.6	3.2
Trading-partner CPI (TWI weighted)	3.2	2.7	2.3	2.3	1.0	1.2	1.9	1.9	2.0	2.2	2.3

Source: RBNZ

ISSUES CURRENTLY UNDER CONSIDERATION BY THE NZFMA

Self-assessment of benchmark rates (BKBM) to IOSOCO principles

The NZFMA recently embarked on a self-assessment and has a number of recommendations to improve BKBM's compliance with the IOSCO principles. The two main recommendations are seeking an external audit of BKBM to the IOSCO principles and the implementation of a fall-back benchmark rate. The self-assessment had passed the committee stage and will soon go to the NZFMA Board for final sign-off. Work has already commenced on the external audit and identification of possible fall-back rates. The NZFMA will consult widely and seek feedback before selecting an appropriate fall-back benchmark rate.

EU BMR

New Zealand intends to seek equivalency to meet EU BMR due to the large derivative exposures NZ banks have with European entities. Without this equivalency NZ banks would expect to see a significant reduction in liquidity which would negatively impact effective hedging of debt issuance, as well as greater credit risk concentration from hedging activities. Further, a reduction in offshore participation in NZ dollar dominated capital markets could impact the banks' overall funding costs.

Work is well underway to introduce legislation that will allow the conduct regulator, the Financial Markets Authority, to licence benchmark administrators. The relevant government department has also engaged with the European Commission and the application process will soon commence, ahead of the new legislation being passed into law hopefully in late 2019.

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Margin on uncleared derivatives

With the global move to the central clearing of derivatives, prudential regulators are moving to update margining requirements for those derivatives that are not centrally cleared in order to reduce systemic counterparty risk. In the case of Australia, APRA, the prudential regulator, has introduced law changes that will impact on New Zealand subsidiaries and branches of Australian Banks that may not be enforceable or introduce legal ambiguity under New Zealand's law. Changes to New Zealand legislation are currently underway and it is expected that the necessary legislation will be passed in Q2 or Q3 2019.

ASIC Consultation Paper 301 – Foreign financial service providers

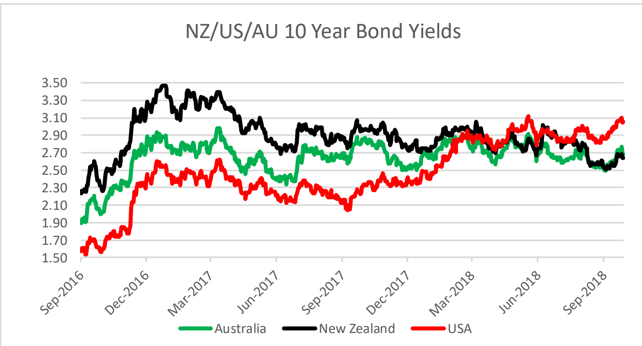
ASIC have issued a consultation paper that could have significant unintended consequences for NZ based financial services providers into Australia. The consultation paper introduced an intent to strengthen the existing wholesale licensing regime by removing an exemption for NZ based financial service providers. This would mean that foreign financial services providers would be required to be registered and obtain a license. This could be a costly exercise and add an additional burden to compliance obligations.

The NZFMA submission focused on the adage that any regulation needs to be proportionate to the problem and the risks it seeks to mitigate. Given that there are no known behaviour issues with NZ based financial institutions operating into Australia, what is the case for change? The submission also leveraged on the Closer Economic Relations agreement (CER) between Australia and New Zealand, an adequate regulatory regime in NZ and certain exemptions enjoyed by Australian financial institutions operating into the NZ market.

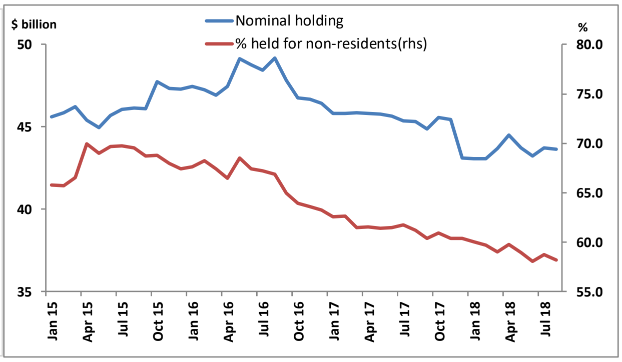
NEW ZEALAND CAPITAL MARKETS

Bond markets

Domestic bond yields have risen recently in line with rising global bond yields, although to a lesser degree, with the Federal Open Market Committee continuing its tightening cycle and US ten-year bond yields trading around the 3% level. As a result, NZ spreads to the US and Australian 10-year bond yields have turned negative following a long period of positive spreads. This has led to a fall in offshore holdings of New Zealand Government securities and can partially explain the lower exchange rate.



Source RBNZ



Source RBNZ

Despite this the NZDMO are still seeing good demand at their regular auctions and they continue to issue both mid-term and longer-term bonds to take advantage of favourable funding conditions. The NZDMO's bond programs are forecast to be circa $8 billion over the next few years. The next bond maturity is 15 March 2019 and the NZDMO has been actively repurchasing this bond. With less than 6 months to maturity the RBNZ has since taken on the role of repurchasing as many of the remaining bonds as it can to assist with liquidity management.

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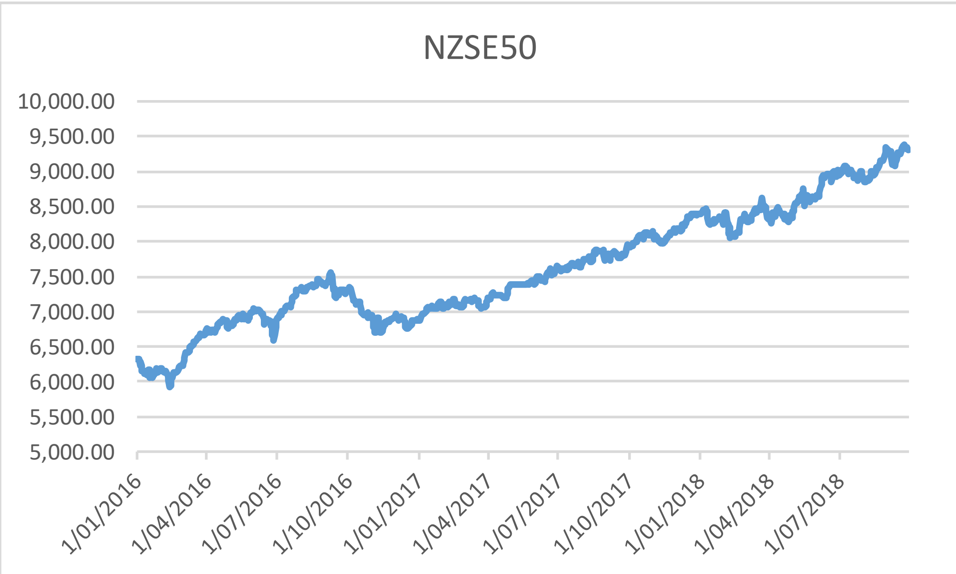
Housing New Zealand (HNZ), a crown agency, recently resurrected its bond program announcing it would issue NZ$1 billion of debt prior to 30 June 2019. The program is raising capital for the Government's "Kiwibuild" initiative which aims to increase the stock of public housing by 6,400 homes over the next four years, predominantly in Auckland. On 1 June 2018 HNZ issued NZ$500 million of five- and seven-year bonds at a margin to NZ Government bonds of 32 and 48 basis points respectively.

The issuance of NZ dollar Supranational/Agency bonds, or Kauri bonds, has stabilised over 2018 having fallen during 2017. Total outstanding sits just above NZ$26 billion, with non-resident holdings steady around 46%. Issuers and investors alike continue to favour the five-year sector with approximately NZ$5 billion issued so far this year at margins to New Zealand Government bonds of between 52 to 80 basis points.

NEW ZEALAND EQUITY MARKETS

To date, the NZX50 has had another strong year growing 11% in the first nine months of 2018 to be one of the best performing indexes globally. Diminishing uncertainty following last year's general election, continuing strong performance of international bourses and good investor demand, especially from international investors have all supported this growth. The company reporting season produced results broadly in line with consensus, although guidance for the next 12 months are slightly lower. The strong performance of the New Zealand market reflected a number of the larger-cap stocks, such as a2 Milk, Ryman and Fisher & Paykel Healthcare, driving the market ahead. The weaker New Zealand dollar also assisted sentiment and income for NZX50 companies that rely on offshore income.



Source: RBNZ, NZX.

However, many analysts are sceptical that the growth in the NZX50 can be maintained into 2019. Domestically, falling business confidence along with rising interest rates globally are likely to dampen demand to invest in New Zealand companies. The construction sector is also in a weak position with poor results and in some cases insolvencies in 2018. This has been caused by rising costs and the sector is currently restructuring, a process that may take some time. Initial Public Offerings (IPOs) remained thin in 2018, at levels similar to 2017. However, analysts are confident that 2019 may see an improvement in the number of IPOs with one large company expected to come to the market.